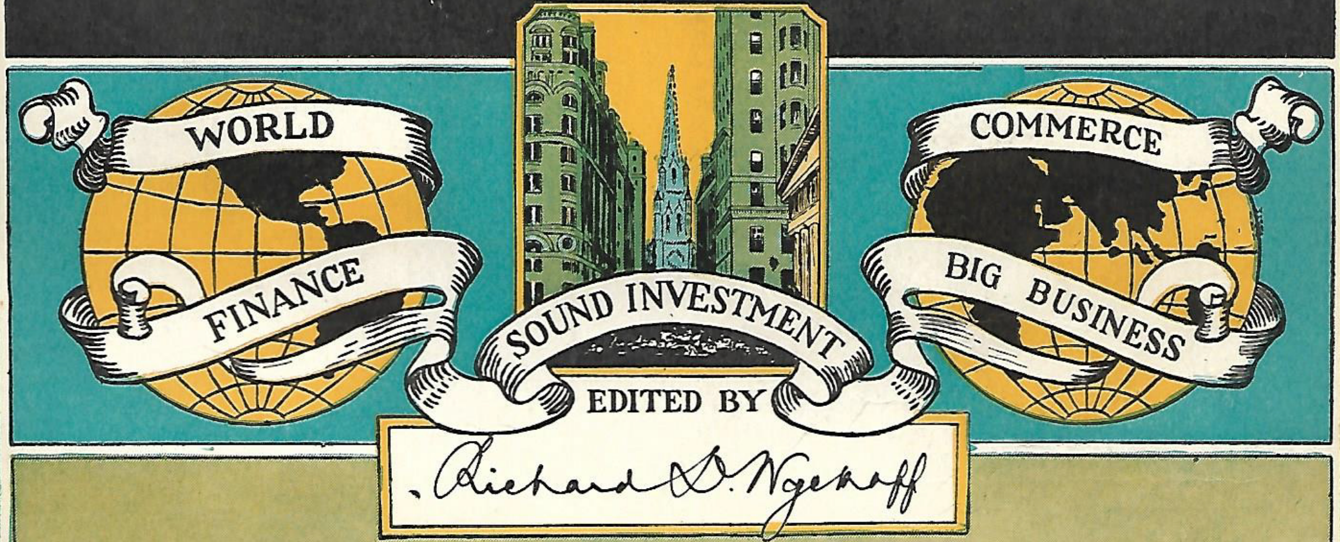
WHY MANY GOOD BUSINESS MEN ARE UNSUCCESSFUL INVESTORS

The MAGAZINE of WALL STREET



How Stocks Act After Presidential Nominations

What the Advance in Wheat and Corn Means

By R. F. Grant

President U. S. Chamber of Commerce

Eight Interesting Profit-Making Opportunities in Industrials

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AUGUST 2nd, 1924

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School for Traders & Investors

Thirty-Sixth Lesson

How to Commit Financial Suicide

A Concrete Example of the Dire Effects of "Overtrading"

IN our last lesson we presented a list of ten cardinal principles of trading. The first and most important admonition was, "Do not overtrade." It was pointed out that the violation of this principle was the direct or indirect cause of more losses than any other indiscretion in market operations.

Overtrading is dealing in more shares of stock than the available capital justifies. It is the effect of following that insidious impulse to "get rich quick." It is a form of credit overextension that makes the trader's position vulnerable to even a moderate reaction, and places his capital in jeopardy.

One who buys more stock than his capital will margin properly according to the customary regulation of a first-class broker, is acting on the assumption that the market's next move *cannot* be against him, but *must* be in his favor. This assumption is unwarranted according to any mathematical theory of chance. Not only is it contrary to sound trading practice, but it is not even a fair gamble. Such extension usually takes place in conjunction with the violation of the principle "buy during weakness," thus reducing the chances of a favorable new position, and at the same time it increases the probability of serious impairment of capital by simply doubling up the possible loss in case of adverse price movement. It is the reverse of common sense.

An Illustration of Overtrading

To illustrate the effect of overtrading, we present the following practical example: Our graph shows the range of the average price of five stocks from the beginning of April to early July. Suppose our "get rich quick" trader buys 100 shares of each of the five issues at the ideal level of 85 on April 22 (point A on graph) and agrees to maintain a margin of 20 points. The original capital required to carry this line is $10,000. Odd-lot traders would require proportionate capital and would be under the additional handicap of odd-lot broker's commissions.

At "B," the average price has advanced to 90, thus adding 5 points, or $2,500 to our trader's equity which now stands at $12,500. He becomes enthusiastic. The idea of standing pat or realizing a part of his profits on strength to provide additional buying power in a reaction does not occur to him. He figures that he can margin another 100 shares at least, so he makes the additional purchase. He now holds 600 shares, requiring $12,000 margin.

The natural normal reaction takes place, going more than half way back, as fate usually arranges matters under such circumstances, and the average price of the 600 shares declines 4 points to 86 at "C." This wipes out $2,400 of equity, reducing the margin to $10,100, or $1,900 short of 20 points. In order to maintain his position, our trader must either put up $1,900 or cut his line down to 500 shares by closing out 100 shares at a loss of $400.

Next day the market recovers, but our trader has no additional buying power,

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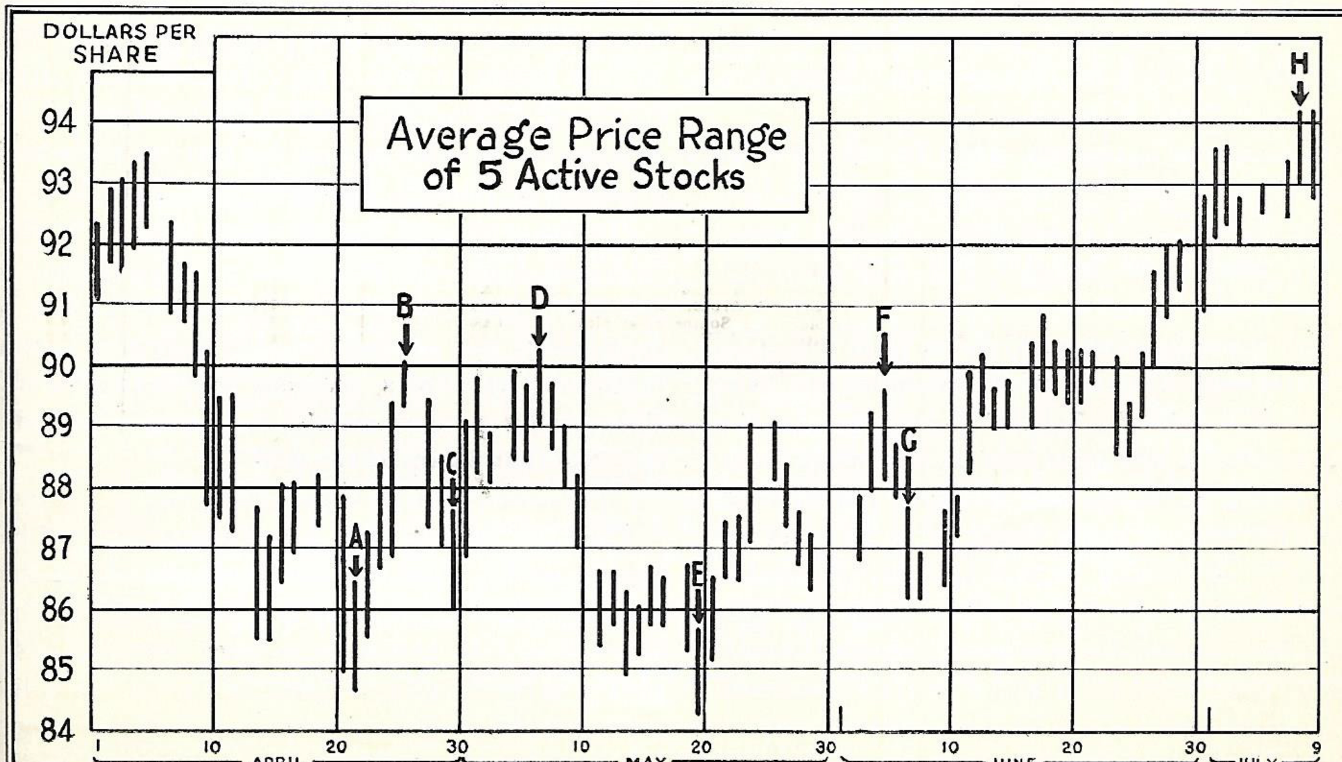

securities. In the case of both the preferred stocks, indeed, it would probably be more accurate, from a strictly investment point of view, to class them as "business men's investments." They are subject to sharp fluctuation and of course do not have the same strong claim upon the properties involved as an underlying mortgage would have. Hence, those not in a position to assume a business man's risk—which means a comparatively substantial risk—might better seek other avenues for their funds.

In short, these recommendations represent the securities which we, as a young man, with our life ahead of us, and a good earnings machine under our hat, would find attractive because they offered the highest income return consonant with a representative margin of safety. Beyond that, nothing is claimed for them.

SCHOOL FOR TRADERS & INVESTORS

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therefore, he must wait, while gnashing his teeth over the fact that his violation of one important principle has forced him automatically to violate another, namely, "do not sell in weakness." Also, he was left unable to follow a third principle, "buy during weakness."

As the market advances, our trader observes evidence of increased strength and notes that prices were supported at a higher level at "C" and at "A," which is usually a bullish sign, at least temporarily. He sees stocks make a higher top at "D" and feels sure they are about to continue the advance that was arrested at "B." His average price has increased 4 points to 90 and his equity has increased $2,000, and now stands at $12,100. The market is very active. Our trader becomes excited. He mistakes "sucker psychology" for "market intuition" (if any such thing exists) and he forgets that common sense and sound principles are always good friends in times of stress. He itches to recoup his recent loss, throws caution to the winds and makes the colossal blunder of doubling-up, on his hunch that this time he will make a killing. He takes the chance, and buys another 500 shares, thus increasing his line to 1,000 shares, and reducing his marginal protection to about 12 points, kidding himself with the hope that a substantial advance is under way, and with the promise that "hereafter" he will settle back into more conservative methods.

How the "Suicide Bug" Works

Now let us see how the financial suicide bug gets in its nefarious work. Following a flurry of activity at "D" the market begins to ease off and then slumps to 85 or under, at "E"—a decline of over 5 full points.

After the smoke clears away our trader learns that his equity has been pared down $5,000, leaving $7,100, or enough to margin 300 or 400 shares, making it necessary to unload 600 or 700 shares of excess baggage at a crushing loss.

The irony of this situation lies in the

fact that our trader is without sufficient buying power to participate in the subsequent orderly advance to above 94, at "H," which would have left his original commitment showing a profit of 9 full points, equivalent to $4,500, and his equity at $14,500.

If our trader with his remaining $7,100 persists in plunging, and continues to pyramid on every advance, without adequate protection, it will not be long until a moderate reaction wipes out his equity entirely. This constitutes financial suicide.

What's the answer?—*Don't overtrade.*

PRESENT POSITION OF THE STOCK MARKET

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better, and the added effect of strength in these groups should further augment the average of the industrials and thus aid the average price of fifty stocks.

In the above we have mentioned only one or two of the most important factors. There are many others. For example, the revival in business which is beginning to get under way; the fact that confidence is being restored; that most of the large corporations, having paid off their bank loans or funded their indebtedness, are now better supplied with working capital than ever before, carrying smaller inventories and keeping their organizations together during dull times. Industrial corporations are in the pink of condition for such a revival.

Nor have we discussed the effect of the enormous gold supply in this country, which is being augmented at the rate of about thirty million dollars a month, forming a basis for several times that much credit. Nor the vastly increased purchasing power of the farming community, which after several years of comparative hardships, is now on the way to benefit itself and everyone else in the country. To say that there are no possibilities of increased dividends among industrial stocks which make up the averages, would be putting a short halter on the business expansion possibilities just ahead.

While it does not pay to grow too enthusiastic (speaking for ourselves, we believe our feet are very much on the ground), we cannot as yet form any definite conclusions as to when and at what particular levels this average price will stop rising. We are now in a very interesting and highly important period in the world's history. The best and safest method of procedure, therefore, is to maintain an open mind, continue in harmony with the strong upward trend now in force, and be watchful for such turn in events as will justify an altered attitude.

For articles to appear in the August 16th Issue see Page 537.